IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

77-
No. 1088

CHESTNUTT CORPORATION,

Petitioner,

—v.—

MILDRED GALFAND,

—and—

AMERICAN INVESTORS FUND, INC.,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONER'S REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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Introduction

Respondent's brief after nearly five years of litigation cannot quote the language of any statute under which Mrs. Galfand can claim; cannot show any injury to herself or to any past or present shareholder; necessarily admits the Fund itself has sought and obtained substantial benefit from prospective personal services to be rendered in the future which it sought and obtained by action of the body of shareholders in annual meetings in four separate years; and argues that it is unimportant that the Courts below

have mandated that subjective conjectures as to ephemeral stock market values shall supplant objective existing facts as the standard of materiality under the securities laws.

All this renders her cry of feigned anguish reminiscent of the clamor in England upon the adoption of the Gregorian Calendar: "Give us back our eleven days!", as if one might claim legal injury upon redesignated equinox.

However intense may be respondent Mrs. Galfand's vicarious solicitude for fellow shareholders, their measured enrichment through voting for and acceptance of future services hardly renders this a "unique" case upon "non-recurring facts" any more than did the "unique" suicide of Mr. Nay and attendant termination of his "mail rule" put *scienter* beyond consideration on account of "non-recurring facts" of negligence. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

I

There Was No Violation of the Investment Company Act of 1940.

A. Nothing Herein Comes Under the Language of the Statute to Create Liability at Law.

Her brief in opposition is an avoidance of statute and confession of common law.

To quote the language of Section 36(b) of the Act* (the only statutory section pleaded and the sole basis of the damage award) would refute her case. She did not claim the advisory fee "compensation" was excessive or that the adviser received any other "payments."

Nowhere does she seek to justify a statutory penalty, or the Court of Appeals language (63a):

* 15 U.S.C. 80a *et seq.*, §35(b). Petition Appendix, 3a-5a.

> ". . . to avoid penalizing the adviser not only for cost increases beyond its control, but also for depreciation of the Fund's net assets."

Nowhere does she refer to Section (10)(d)(6) of the Act* under which petitioner had a statutory right to a full 1% advisory fee, or seek to explain how the 0.57% advisory fee paid for 1973 and the 0.61% advisory fee paid for 1974 led to "unjust enrichment" (65a) of the adviser, requiring it to pay a windfall over to the Fund for the Fund's own expenses contrary to what was ". . . stipulated to be *true*" that "the Fund is an open-end investment company incorporated in New York of the no-load variety, *as described in Section 10(d)* . . ." (Emphasis added) (Stip. ¶ 1, A-29, A-30).

B. No Shareholder Including Respondent Nor the Corporation Suffered Injury.

Nowhere does respondent even contend that she or any other past or present shareholder was injured, and it affirmatively appears that the corporate entity continued to reap increasing benefits from the future services repeatedly approved by the body of shareholders.

The four annual approvals by the corporate entity of a personal service contract under which the corporate entity continued to enjoy the benefits preclude that entity itself from recovering damage, since even were there to have been an infirmity in the first approval, under *Perma-Life Mufflers, Inc.* v. *International Parts Corp.*, 392 U.S. 134, 140 (1968):

> "The possible beneficial byproducts of a [violation] . . . can *of course* be taken into account in computing damages." (Emphasis added),

* Petition Appendix, 1a-2a.

and further under *Brunswick Corp.* v. *Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 97 S.Ct. 690, at 697:

> "to the contrary it is far from clear that the loss of windfall profits that would have accrued . . . even constitutes 'injury' within the meaning of §4."

Respondent cannot point to anything in the Act which grants the Fund windfall reimbursement of its own expenses paid to third parties.

II

The Proxy Statement Was True and Not Misleading.

Respondent's brief emphasizes that the decisions below require future guesswork and subjective "reasons" (64a) in proxy statements. Petitioner has been held liable for failure to predict the "specific future market values" of the Fund's portfolio which *"might"* have led to exceeding the former 1% limitation by 2/100,000 ths. of a penny per share, which materiality is contrary to

> ". . . balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." *SEC* v. *Texas Gulf Sulphur*, 401 F.2d 833, 849 (2 Cir. 1968),

and although even "educated guesses or predictions" have not heretofore been required. *Id.*, at 848.

As Judge McCree put it:

> "In short the law mandates disclosure only of existing material facts." *Arber* v. *Essex Wire Corp.*, 490 F.2d 414, 421 (6 Cir.), *cert. den.*, 419 U.S. 830 (1974).

The Second Circuit has now reemphasized the subjective nature of this case holding in *Cole* v. *Schenley Industries, Inc.*, 563 F.2d 35, 42 (1977):

> "This is not a case where the proxy statement misleads shareholders by giving one purpose when in fact there are several. *Galfand* v. *Chestnutt Corp.*, 545 F.2d 807, 813 (2d Cir. 1976)."

Plainly, the *sole* purpose of the proposal as disclosed in the proxy statement was to reduce a contingent "risk" to the adviser (Pet., p. 12):

> ". . . however, the higher allowable expense ratio limitation would benefit the Adviser by *reducing the risk* that some or all of the advisory fee would have to be reimbursed to the Fund due to an increase in rates for other expenses or changes in the average account size of American Investors Fund shareholders. No higher fees or costs would have been incurred by the Fund had the proposed new Agreement been in effect in 1972." (Emphasis added)

The same circuit has now gone even farther in *Burks* v. *Lasker* (No. 77-7060, January 11, 1978), to state (Slip. op., 998):

> "Thus, in *Galfand* v. *Chestnutt*, 545 F.2d 807 (2d Cir. 1976), we found that the investment adviser had abused its position of trust by securing a favorable modification of its advisory contract without fully disclosing to the fund's directors the ramifications of the changes."

Nowhere does respondent, or the decisions below, point to a single misstatement of, or failure to disclose, ***any*** existing fact to either the Board or the shareholders.

The outside directors knew on a weekly basis as much about the Fund as the adviser (Pet. 10, 15) as the undisputed testimony of outside director Ulrich (a CPA and presently Vice-President and Controller of Pan-Am Airways) stated:

> "Q. In what way do the directors know as to the market performance of American Investors Fund?
>
> A. We received a weekly listing of all stock purchased, sold, a listing of the portfolio, and a balance sheet which comes in the mail.
>
> Q. Is there anything else contained in that report, weekly report?
>
> A. We also get Mr. Chestnutt's market advice letter." (163a)
>
> • • •
>
> "Q. Does it show any comparison between the Fund and the market?
>
> A. I'm not with you. I don't know which part you are talking about. It's got the market values and it gives the net value of the individual stocks in the portfolio." (164a)

Failure of respondent's counsel to confirm our representation (Pet., 14) as to egregious misstatements below cannot be explained.

Since actual true net assets were disclosed and the actual formula, as well as the actual advisory fees (Pet., 10), ". . . respondent [does] not indicate how [she] might have acted differently . . ." no matter what conjectures or other information might have been included. *Santa Fe Industries, Inc.* v. *Green*, —— U.S. ——, 97 S.Ct. 1292, 1301, n.14.

She knew the truth. She sued for injunction. Since she was fully informed of all facts and all legal rights including "appraisal" by redemption, it is apparent that this case undermines "materiality" from *Texas Gulf, supra,* to *TSC Industries, Inc.* v. *Northway,* 426 U.S. 438 (1976). As to any fear she might have that others might not understand plain English: "We suspect the argument rests on an under-estimation of the public." *Bates* v. *State Bar of Arizona,* —— U.S. ——, 97 S.Ct. 2691, 2703-04.

CONCLUSION

This Court has emphatically forbidden lower courts to supply federal common law to fill supposed gaps in statutes. The even greater importance of this case is that federal common law has been employed to overrule statutes, rendering Congress helpless and ineffectual, and at the same time the decisions below substitute subjective guesswork for materiality.

For all the reasons set forth in the petition and herein it is respectfully submitted that the writ should be granted and the decision below reversed.

Respectfully submitted,

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